

H. C. FOSTER & COMPANY

Retirement and Welfare Plan Actuaries

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Retirement Plan Basics – Summer 2017

A late age 30s married couple contacted us recently with concerns about their future retirement income security, we will call them Ann and John. Ann operates a medical practice, and provides specialized independent contractor services for others in her field. John provides specialized production services in the entertainment industry. Both have contributed to Simple IRA arrangements for many years, there are no non-owner employees, and each needs to minimize taxable Form W-2 Wages.

Our Question and Answer session unfolded as follows:

Q. Our businesses employ only ourselves, can we sponsor a true tax qualified retirement plan?

A. Yes, any sole proprietor or incorporated business, profit or non-profit, having one or more wage earners can sponsor a tax qualified retirement plan. A “one-employee” business is typically the business owner and his spouse. Separate businesses can adopt a single plan that meets their needs.

Q. Would a retirement plan we sponsor be a SEP or IRA-type of plan?

A. Neither, a single employer, tax qualified retirement plan sponsored by an employer falls under different IRS and DOL regulations applicable to the U.S. Private Pension System.

Q. What are the advantages of a privately sponsored retirement plan?

A. The three main advantages include: (a) sales charges for pooled investment funds can be much less due to economies of scale with charges explicitly displayed, not hidden through reductions in investment returns; (b) the employer selects all investment sources and services providers with their costs explicitly charged; and, (c) the employer easily performs annual administrative and employee disclosure functions at the least possible cost with outside support only as needed.

Q. What is the single largest advantage of an employer sponsored, self-administered retirement plan that avoids the retail market?

A. Reducing investment management and administrative charges by only 1.5% of total assets produces much larger retirement income. For example, with annual \$5,000 contributions at the end of each year, a net investment return of 6.0% per year for 25 years accumulates to \$274,000 versus \$223,000 from a 4.5% net annual investment return. This is a \$51,000 savings advantage over 25 years. See <https://www.bls.gov/ppi/ppiinvestadvice.htm> for mutual fund charges compared to private portfolio management charges. Actual investment management and administrative charges in a specific situation may be difficult to obtain despite recent DOL efforts to expand fee disclosures.

Q. Can we have a tax qualified retirement plan without the support of an insurance company or investment broker?

A. Yes. The components of a privately sponsored retirement plan include: (a) a legal plan document obtained from a benefits consulting or law firm not affiliated with investment product sources; (b) an arrangement with a discount investment brokerage source for risk tolerable investment selections with no restrictions on investment selections and sources; and, (c) internal administrative processing with support services through independent advisors who serve subject to their satisfactory performance. Plan document work should be reviewed by the business' legal counsel.

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Q. What about annual administration?

A. A tax qualified retirement plan requires annual Form 5500 filings with the assistance of a benefits consulting firm or accounting firm; but, permits less than full vesting and other features that reduce funding costs. A defined benefit plan covering non-owner employees for Ann would not be covered under the Pension Benefit Guaranty Corporation (PBGC) requiring annual premiums until it covers twenty-five (25) or more active employees. John's defined benefit plan would require PBGC coverage when he has non-owner, full-time employees.

Q. Can we transfer our Simple IRA accounts to the new plan?

A. Yes, if the plan document permits such. The transferred assets would be maintained in separate accounts you control. Transfer of assets from existing investment sources should be "in-kind" to the extent possible to avoid withdrawal fees, market value adjustments, and re-investment charges. Subsequent employees entering plan coverage would have the same rights to transfer their IRA accounts to the plan after a waiting period. See https://www.irs.gov/pub/irs-tege/rollover_chart.pdf.

Ann and John had no idea they could gain control over their retirement plan functions. We emphasized the following points:

1. IRA-type plans and prototype Section 401(k) arrangements are retail market products promoted by commissioned sales agents who prey upon individuals and employee groups through pre-packaged arrangements. One of their major selling points is that the required legal documents, investment services, and required disclosures of plan information are "free of charges", i.e., their costs and sales charges are assessed against investment earnings. Retail retirement plan arrangements do not permit the full range of retirement plan options available under IRS regulations, and limit the investment source to the retail provider. And, employer sponsored arrangements require many of the compliance and administrative requirements of a true retirement plan.
2. An employer's self-administered retirement plan removes the middle man from all plan functions to minimize charges for investment management and other services paid directly by the employer. The employer knows explicitly his costs for outside administrative services and investment charges.
3. The IRA and Section 401(k) movements provide adequate retirement income to only a small portion of targeted employees. Congress never intended for IRAs and Section 401(k) plans to replace the Private Pension System. See https://www.bls.gov/ncs/ebs/retirement_data.htm for data regarding retirement benefits under different arrangements.

Ann and John adopted an uncomplicated discretionary Profit Sharing Plan (PSP) that includes no Section 401(k) provisions. The 25% of compensation limitation on annual contributions up to \$54,000 for 2017 meets their pension savings goals for now.

As they age with increasing compensations and hire employees, a defined benefit plan will minimize funding costs for employees, and direct significantly more of the contributions to Ann and John. The PSP will be amended to permit discretionary employer contributions that offset the funding requirements of the defined benefit plan under Floor-offset provisions. Younger employees' benefits will be funded primarily through the PSP. Older, newly hired professional employees will be funded primarily through the defined benefit plan with direct compensation reductions to fund their benefits. With reasonable contribution levels replacing taxable Form W-2 Wages, we estimate Ann and John will each accumulate over \$1.5 million in their privately sponsored retirement plans by the time they retire.

Please call or e-mail any questions or comments.